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## BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

KRISTIN K. MAYES, Chairman  
GARY PIERCE  
PAUL NEWMAN  
SANDRA D. KENNEDY  
BOB STUMP

Arizona Corporation Commission

DOCKETED

JUN 16 2009

DOCKETED BY

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In the matter of

MERRILL LYNCH, PIERCE, FENNER &  
SMITH INCORPORATED,

Respondent.

DOCKET NO. S-03497A-09-0242

DECISION NO. 71162

ORDER TO CEASE AND DESIST, ORDER FOR  
ADMINISTRATIVE PENALTIES, AND  
CONSENT TO SAME  
BY: RESPONDENT MERRILL LYNCH,  
PIERCE, FENNER & SMITH INCORPORATED

WHEREAS, Merrill, Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") is a  
dealer registered in the state of Arizona, with a Central Registration Depository ("CRD") number  
of 7691; and

WHEREAS, coordinated investigations into Merrill Lynch's activities in connection with  
its marketing and sale of financial instruments known as auction rate securities ("ARS") to retail  
and other customers have been conducted by a multistate task force; and

WHEREAS, Merrill Lynch has cooperated with regulators conducting the investigations by  
responding to inquiries, providing documentary evidence and other materials, and providing  
regulators with access to facts relating to the investigations; and

WHEREAS, Merrill Lynch has advised regulators of its agreement to resolve the  
investigations relating to its marketing and sale of ARS on the terms specified in this  
Administrative Consent Order (the "Order"); and

WHEREAS, Merrill Lynch agrees to implement certain changes with respect to its  
marketing and sale of ARS, and to make certain payments in accordance with the terms of this  
Order; and

WHEREAS, Merrill Lynch elects to permanently waive any right to a hearing and appeal

1 under Articles 11 and 12 of the Securities Act of Arizona, A.R.S. § 44-1801 *et seq.* ("Securities  
2 Act") with respect to this Order; and

3 WHEREAS, solely for the purposes of terminating the multistate task force investigations,  
4 including the investigation by the Arizona Corporation Commission ("Commission"), and in  
5 settlement of the issues contained in this Order, Merrill Lynch, without admitting or denying the  
6 Statement of Facts and Conclusions of Law contained in this Order, and without an adjudication of  
7 any issue of law or fact, consents to the entry of this Order.

8 NOW, THEREFORE, the Commission, as administrator of the Securities Act, hereby  
9 enters this Order:

10 **I.**

11 **STATEMENT OF FACTS**

12 **A. Background Mechanics of Auction Rate Securities.**

13 1. ARS as a general term refers to long-term debt or equity instruments tied to short-  
14 term interest rates that are reset periodically through an auction process.

15 2. At auction, ARS always trade at par, with the yield of the instruments being  
16 adjusted by the movements of interest rates set by the Dutch auction.

17 3. In the Dutch auction, a security holder had three options, the holder could: (1) hold;  
18 (2) purchase or sell; or (3) purchase and hold at rate.

19 4. Investors looking to acquire ARS bid into the auction at the rate and quantity that  
20 they were willing to hold the securities.

21 5. Orders for the available quantity of ARS are then filled, starting with the lowest bid  
22 rate up until all the shares offered for sale in the auction are allocated.

23 6. The rate at which the final share from the auction is allocated is the clearing rate,  
24 and sets the rate to be paid for the entire issue until the next auction.

25 7. If there are not enough purchasers the auction fails, no shares change hands, and the  
26 rate resets to a rate that is prescribed in the instrument's offering documents.

**B. Merrill Lynch Marketed And Sold Auction Rate Securities As Safe, Liquid Short-Term Investments.**

1. Merrill Lynch Marketed Auction Rate Securities as Safe, Liquid Investments.

8. Merrill Lynch marketed and sold ARS as money market like instruments, which were safe and liquid.

9. Merrill Lynch additionally used research pieces to market ARS to customers.

10. Financial advisers ("FAs") would often forward Merrill Lynch marketing pieces to customers to reassure them of the safety and value of the instruments.

11. FAs who sold ARS were not required to provide customers with disclosures, instead customers would receive customer's trade confirmations directing customers to where they could access Merrill Lynch's "Auction Rate Practices and Procedures."

12. On March 15, 2006, Merrill Lynch ended its practice of sending ARS purchasers a "Master Purchasers Letter." The Master Purchasers Letter was a disclosure document that all purchasers of ARS had been required to sign and return to Merrill Lynch.

13. Merrill Lynch's policies and procedures did disclose some important elements of its ARS program, including that Merrill Lynch plays multiple roles in the ARS market, that Merrill Lynch's interest may differ from those of its clients who purchased ARS, that Merrill Lynch is permitted but not obligated to submit orders for its own account and routinely does, and that a purchaser's ability to sell the purchaser's ARS may be limited.

14. Yet, since Merrill Lynch FAs were not required to affirmatively disclose these practices prior to selling a client ARS, purchasers were largely unaware of Merrill Lynch's practices in supporting its ARS program.

15. Merrill Lynch did not undertake any analysis of whether any customers actually went to the website discussing its practices and procedures to review them.

2. Merrill Used Triple-A Rating as a Selling Point for Auction Rate Securities Even After it had Allowed to Fail Certain Triple-A Rated Auction Rate Securities.

16. The fact that its ARS carried a AAA rating was an important marketing point for Merrill Lynch. The AAA rating on ARS was routinely touted in marketing materials, as well as research pieces that discussed ARS and their safety.

17. Marketing materials produced by the ARS desk promoted ARS as follows:

- **Auction Market Securities provide many advantages for investors**

- Large and liquid market with over \$306 billion currently outstanding
- High quality credits with over 92% of the market rated AAA
- Incremental yield to comparable securities such as commercial paper and money market funds
- Taxable, tax advantaged and tax exempt investment options

18. A triple-A rating is a long term credit rating.

19. The AAA rating on Merrill Lynch's ARS do not speak to an investor's ability to liquidate the instrument through auction at par.

20. A number of the collateralized debt obligations and other auction rate securities underwritten and offered by Merrill Lynch carried the AAA rating from major rating agencies.

21. In August 2007, as described below, Merrill ceased supporting the auctions of a number of its triple-A rated action rate securities.

22. Those securities became illiquid and subsequently lost most of their market value.

23. Despite the fact that Merrill had failed a number of triple-A auction-rate securities in August 2007, subsequent to August 2007, Merrill continued to use the AAA rating as a selling point for auction rate securities.

24. Merrill Lynch was aware—yet did not disclose to investors—that certain auction rate securities retained their triple-A rating after their auctions had failed.

1           25.     Merrill Lynch was aware—yet did not disclose to investors—that the triple-A rating  
2 did not provide protection against Merrill deciding to no longer support its auction program.

3           26.     Nonetheless, Merrill Lynch relied heavily on the triple-A rating to convince  
4 investors the auction rate securities it was selling were safe and principal protected.

5           **C.     Merrill Lynch's Auction Rate Securities Program Stands in Contrast to its**  
6           **Representations to Customers.**

7                   1.     Merrill Lynch's Auction Rate Program Provided Issuers with Inexpensive  
8                   Financing and Generated Substantial Fees for Merrill Lynch.

9           27.     Merrill Lynch's ARS program was funded by issuers of ARS, who paid Merrill  
Lynch fees to underwrite securities and remarket them.

10          28.     The ARS market allowed issuers to achieve long-term financing at short-term rates.

11          29.     The Merrill Lynch ARS program had four branches, an investment bank that  
12 underwrote ARS, the ARS desk that acted as a remarketing agent for the securities, a sales force  
13 that sold ARS to retail and other clients, and a research division that assisted the ARS desk in  
14 placing ARS.

15          30.     The ARS that Merrill Lynch underwrote then sold to its clients consisted of auction  
16 preferred shares ("APS"), with perpetual maturity, with dividends that reset every 7 to 35 days at  
17 auction, or long-term debt instruments, issued by municipalities and student loan organizations  
18 with maturities of 20-40 years with interest rates that reset through the same process.

19          31.     Due to the upward sloping yield curve, issuers of long-term instruments would  
20 typically have to pay higher interest rates.

21          32.     By supporting the auction mechanism, both in its role as a remarketing agent and by  
22 purchasing ARS at auction to avoid failures, Merrill Lynch allowed issuers to have long-term  
financing at short-term rates.

23          33.     Purchasers of ARS were willing to accept short-term rates because they believed  
24 they would have access to their principal on short-term notice at the next auction, and they would  
25

1 get a slightly higher rate than a money market fund because they would have to wait until the next  
2 auction to access their money.

3 34. This belief was cultivated by Merrill Lynch and other broker-dealers who used their  
4 own capital to ensure auctions did not fail, and generally touted the 20-year track record of very  
5 rare failures, and creating the impression with investors that there was a deep liquid market for the  
6 securities.

7 35. Due to the practice of Merrill Lynch and other broker-dealers of placing support  
8 bids, for the 20 years prior to August of 2007 there had been only a handful of failed auctions that  
9 prevented investors from accessing their principal.

10 2. Merrill Lynch Generated Significant Fees by Underwriting Auction Rate  
11 Securities with Constrictive Maximum Rates and Selling them to Clients.

12 a. Merrill Lynch Generated Significant Fees Underwriting Auction  
13 Rate Securities and Distributing Them To Clients.

14 36. The investment bank at Merrill Lynch generated significant fees from underwriting  
15 new issuances of ARS. From 2001 through 2008 Merrill Lynch underwrote approximately \$13  
16 billion of APS, earning \$130 million of underwriting fees.

17 37. In order to help move new issues Merrill Lynch awarded FAs who placed new ARS  
18 issues with a placement credits.

19 b. Merrill Lynch Underwrote Auction Rate Securities With Restrictive  
20 Maximum Rates, Which Allowed The Securities To Achieve AAA  
21 Ratings.

22 38. Upon information and belief 92 percent of the auction rate securities that Merrill  
23 Lynch underwrote received a AAA rating from rating agencies such as Fitch and Moodys, and 97  
24 percent had ratings of AA or better.

25 39. AAA ratings from agencies such as Fitch and Moodys signify the rating agencies'  
26 assessment that there is a high likelihood that the security will pay interest or dividends as well as  
principal when due in a timely manner.

1       40.     Maximum rate provisions place a ceiling on the rate of interest at which an auction  
2 can clear, and additionally provide the rate the issuer must pay should auctions fail.

3       41.     When evaluating whether an issuer could make payments as due on its ARS, rating  
4 agencies would look at the terms of the instrument to determine how much interest it may be  
5 obligated to pay. The maximum rate places an absolute cap on the interest or dividend the  
6 instrument will pay, restricting its potential obligations, therefore making it easier for the  
7 instrument to achieve a AAA rating.

8       42.     Once Merrill Lynch stopped placing support bids in the auctions for which it was  
9 the lead broker-dealer, there were auction failures across its program.

10       43.     When auctions fail the rate resets to the maximum rate.

11       44.     The ARS with high maximum rates, typically municipal auction rate certificates  
12 ("ARCS") with maximum rates in the range of 12-15 percent, have drawn investor interest and  
13 have cleared without Merrill Lynch's support.

14       45.     The ARS with low maximum rates, typically taxable and tax-exempt APS with  
15 maximum rates in the range of 3-5 percent, have not drawn investor interest and without Merrill  
16 Lynch's support have continued to fail, leaving investors with illiquid instruments.

17                   c.     Merrill Lynch Additionally Received Fees To Remarket The Auction  
18                             Rate Securities It Underwrote.

19       46.     When Merrill Lynch underwrote an issue of ARS, it typically served as the broker-  
20 dealer or remarketing agent for the issue.

21       47.     Merrill Lynch would typically receive a fee of 25 basis points of the value of the  
22 ARS for which it acted as remarketing agent.

23       48.     Merrill Lynch would share a portion of this fee with FAs in order to incentivize  
24 them to place clients into ARS.

25       49.     Prior to every auction for which Merrill Lynch was the sole or lead broker-dealer,  
26 Merrill Lynch would provide "price talk," a range of bids provided to FAs indicating where Merrill  
Lynch expected auctions to clear.

1        50. All ARS for which Merrill Lynch acted as sole broker-dealer were placed through  
2 Merrill Lynch FAs.

3        51. Under Merrill Lynch's ARS program, as remarketing agent, the ARS desk had the  
4 option but not the obligation to bid in auctions.

5        52. Until August of 2007 Merrill Lynch had a policy of placing support bids into every  
6 auction for which it was sole or lead broker-dealer.

7        53. In August of 2007 Merrill Lynch withdrew its support for certain CDO-backed  
8 ARS.

9        54. When placing a support bid, Merrill Lynch would bid for the entire notional value  
10 of the issue being auctioned, regardless of the size or volume of buy, sell, or hold orders Merrill  
11 Lynch had received.

12        55. By placing support bids for the entire notional value of the issue being auctioned,  
13 Merrill Lynch ensured that no auctions in its ARS program would fail.

14        56. Merrill Lynch often set the rate at which the auctions would clear with its support  
15 bids.

16        57. For the period of January 3, 2006, through May 27, 2008, 5892 auctions for which  
17 Merrill Lynch was the sole lead dealer would have failed but for Merrill Lynch's support bid.

18        58. Investors were not provided with information about the volume of shares that  
19 moved at auction.

20        59. Investors were not provided with information about the level of support from  
21 Merrill Lynch that was required to clear the auction.

22        60. Investors were not informed of how many ARS Merrill Lynch was carrying on its  
23 own inventory as a result of supporting auctions.

24        **D. Auction Rate Securities Inventory Concerns At Merrill Lynch**

- 25            1. Weakness in the Credit Markets Initiated Inventory Concerns In Summer Of  
26                2007.



1           61. Beginning in late July 2007, certain negative market influences surrounding  
2 collateralized debt obligations ("CDOs") and collateralized loan obligations ("CLOs") and a credit  
3 crunch began to negatively impact Merrill Lynch's auction market business.

4           62. As investors began selling these ARS due to concerns about their credit quality  
5 (despite the fact that many were triple-A rated), Merrill Lynch purchased ARS into its own  
6 inventory to make sure those auctions did not fail.

7           63. At a certain point, Merrill Lynch decided to limit the amount of inventory of these  
8 instruments it was taking on and ceased submitting support bids, thus allowing the auctions to fail.

9           64. Merrill Lynch FAs began to seek answers to questions concerning ARS as early as  
10 August 7, 2007.

11           65. FAs from all over the United States sent emails and made telephone calls to request  
12 information from the Global Markets & Investment Banking staff managing the Merrill Lynch  
13 Auction Trading Desk.

14           66. The Auction Desk and the Financial Products Group, along with several of the  
15 supposedly independent research analysts for closed-end funds and Fixed Income/Cash, organized  
16 and participated in Sales Calls during the second and third week of August 2007 in an effort to  
17 clear auctions, reduce the rates of important issuers, and maintain a strong interest in ARS among  
18 the Merrill Lynch FAs all over the country.

19           2.     Communications With Issuers And Others Expressing Concern About The  
20                    Auction Markets.

21           67. As early as August 3, 2007, senior management of Merrill Lynch was requesting a  
22 sample term sheet for AMPS to understand the liquidity and downgrade risk.

23           68. In August 2007, representatives from major issuers in the closed-end fund  
24 investment world were also trying to get a sense of the risks and demand reductions for their  
25 preferred shares.

26           69. None of these growing risks concerning weak demand in the ARS market were  
disclosed to Merrill Lynch clients during the third quarter of 2007.

1        70.    Upon information and belief, Merrill Lynch began, in late 2007, discussing with  
2 issuers, concerns with the auction markets.

3                    3.        Merrill Lynch Surpasses Its Inventory Limit In September 2007, As ARS  
4                                Market Conditions Worsened.

5        71.    In late September, inventory levels rose significantly and the Auction Desk was fast  
6 approaching its limit of \$1 billion dollars.

7        72.    In addition, Merrill Lynch had certain lenders that provided financing for its  
8 inventory of auction rate securities.

9        73.    Those lenders had previously accepted auction rate securities as collateral for the  
10 loans.

11       74.    In the Fall of 2007, certain of these lenders became uncomfortable with the liquidity  
12 of auction rate securities and ceased accepting them as collateral.

13       75.    Merrill did not inform its retail and other customers, to whom it was marketing  
14 auction rate securities as principal protected cash-like instruments, that entities that financed its  
15 inventory no longer accepted certain auction rate securities (even some rated AAA) as collateral.

16                    E.        **Merrill Lynch's Consolidated Effort to Reduce Inventory – A Three Pronged**  
17                                **Approach.**

18                                1.        Calming Fears, Providing Assurances And Motivating Additional Sales Of  
19                                        Auction Rate Securities Through Sales Calls with FAs.

20       76.    Just after the first hint of investor concern with the auction market, the Auction  
21 Desk and Sales and Trading immediately mobilized to stem the tide of negative news. Managers  
22 moved quickly to set up sales calls to provide assurances to FAs and to motivate future sales of  
23 ARS.

24       77.    In late November and early December, with inventory backing up and reaching new  
25 highs at Merrill Lynch, a decision was made to do another national sales call. The formula would  
26 be similar to the successful call made previously in August. Auction Desk personnel would be  
joined by a member or members of the Research Department to reassure and motivate FAs to  
concentrate on selling Auction Desk inventory.

1        78. During the call, there was no discussion regarding the risk of any type of auction  
2 failure, or the likelihood or possibility that any market dislocation could result in retail customers'  
3 cash becoming illiquid.

4        79. Moreover, there was no discussion about the possibility that Merrill Lynch could  
5 decide at any time to stop its support of the auction market or to otherwise withdraw from  
6 supporting the auctions that it sole managed or co-managed.

7        80. There was no mention of the fact that with the pressures that existed in the credit  
8 market since August 2007, any auction failure by any auction dealer could spread contagion to the  
9 rest of the market.

10                    2.        FA Incentives - Increased Production Credits Sales Drive.

11        81. At various times during the second half of 2007, Merrill Lynch provided incentives  
12 in the form of enhanced production credits as a means of motivating FAs to sell ARS to customers  
13 and reduce Merrill Lynch's inventory. Typically, FAs earned 12.5 bps on an annualized basis for  
14 investments in ARS. FAs would then earn a percentage of the 12.5 bps according to a payout grid.

15        82. During periods where enhanced credits were awarded, FAs could earn as much as 8  
16 times that amount (or 100 bps) for sales of ARS. Other enhanced payouts could include payouts of  
17 25 bps, or 50 bps. Similar to regular production credits earned, FAs enhanced production credits  
18 would be applied to the grid resulting in FAs being paid a certain predetermined percentage of the  
19 enhanced production credit.

20                    3.        Coordination with Research

21                            a.        Proactive Involvement From The Supposedly Independent Research  
22 Department To Aid In Sales Efforts.

23        83. Merrill Lynch's Research Department played a pivotal role in assisting sales of  
24 Auction Rate Securities.

1           84.    On at least two occasions during the Fall of 2007, Sales and Trading and the  
2 Auction Desk made direct and specific requests for the Research Department to draft favorable  
3 research pieces regarding the auction market to assist in Sales.

4                           b.       Improper Information Sharing –Between Research and Sales and  
5 Trading.

6           85.    The task force's investigation revealed frequent communications among research,  
7 sales, and trading staff.

8           86.    Merrill Lynch Policy & Procedures Manual (the "Policies Manual") employs a so-  
9 called "Chinese Wall," which is designed to prevent "the misuse of material non-public  
10 information" and to prevent "even the appearance of impropriety."

11           87.    The "Chinese Wall" is designed to "restrict and monitor the flow of information  
12 between the various areas of [Merrill Lynch] such as Global Research, Sales [and] Trading,"  
13 among others "to avoid the misuse of such information and the appearance of impropriety as well  
14 as to manage potential conflicts of interest..."

15           88.    Among those departments that constitute the "Private Side of the Wall" include:  
16 "Investment Banking, including Global Capital Markets and Financing (Equity Capital Markets  
17 and Debt Capital Markets)," and "other departments or individuals that regularly receive inside  
18 information," while the Research Division is on the "Public Side of the Wall."

19           89.    Among the categories of information that cannot be discussed between Sales or  
20 Trading and Research are the levels or amounts of inventory that Merrill Lynch maintained for its  
21 own account.

22           90.    Such information was discussed.

23                           **F.       Improper Influence And Pressure Over Supposedly Independent Research  
24 Personnel.**

25           91.    Merrill Lynch permitted its Sales and Trading and Auction Desk personnel to have  
26 undue influence over its Research Department regarding its coverage of the auction market.

1           92.     In addition to the direct requests of Sales and Trading and the Auction Desk to  
2 ~~Research for positive published material related to the auction market, undue influence was also~~  
3 exercised over the content of the published research reports.

4           93.     Other times, Auction Desk Personnel attempted to directly influence how Research  
5 responded to FA questions during sales calls.

6           **G.     Events Leading To Merrill Lynch's Decision To Stop Broadly Supporting Its**  
7           **Auction Program.**

8           94.     Concerns surrounding the auction market grew more ominous going into the new  
9 year and Merrill Lynch's Auction Desk personnel began to brace for the worst.

10          95.     Likewise, Inventory concerns at Merrill Lynch continued.

11          96.     On January 23, 2008, word began circulating among broker-dealers that Lehman  
12 Brothers had a number of auctions fail the previous day.

13          97.     Concerns were not shared with FAs or retail customers.

14          98.     Between the dates February 1, 2008 and February 8, 2008, staff wrote or contributed  
15 to approximately three published research pieces, including: Fixed Income Digest, "Preserve  
16 Income Lock in Yields"; Fixed Income Digest Supplement, "Auction Market Securities" and  
17 Auction Market Value Sheet, "Back to Basics In The Auction Market." Each of these publications  
continued to recommend that investors should feel confident about the auction market.

18          99.     On or about February 1, 2008, Merrill Lynch's Research Department published a  
19 volume of its Fixed Income Digest, entitled "Preserve Income Lock in Yields." The cover page  
20 included a section entitled "Preserve Income." The last sentence of the section provided: "For  
21 funds that investors need to keep liquid, we continue to find the best value in auction market  
22 securities." Inside the research piece, there was a subheading: "For Cash Holdings: auction market  
23 securities," which recommended, [n]aturally, most investors need to keep some portion of their  
24 portfolios in liquid cash-like instruments. We find auction market securities (AMS) to be better  
25 alternative than money funds for these purposes for investors with larger amounts to invest." The  
26 section was followed immediately by another section dedicated to: "Answering Your Questions

1 About Auction Market Securities" which responded to common questions relating to the auction  
2 markets at the time.

3 100. On February 4, 2008, the Research Department re-published the "Answering  
4 Questions" piece on its own as a supplement to the Fixed Income Digest in part, because of  
5 questions the Research Department was getting calls and that FAs were likely having a problem  
6 locating the information in the otherwise lengthy February 1, 2008 publication.

7 101. On the evening of February 12, 2008, Merrill Lynch executives decided to cease  
8 supporting its auction rate securities program and intentionally allowed the vast majority of their  
9 auctions to fail the following day.

10 102. Merrill Lynch's decision to stop broadly supporting its auction program was made  
11 without any real consideration or analysis of its effect on retail and other investors holding the  
12 securities.

13  
14 **H. Merrill Lynch Has Marked Down Its Own Inventory of Auction Rate**  
15 **Securities, But Still has Not Marked Down The Estimated Value Of The**  
16 **Auction Rate Securities On Its Clients' Account Statements.**

17 103. Merrill Lynch has marked down the value of its own inventory of auction rate  
18 securities, yet has not marked down the value of those same auction rate securities in its client  
19 statements.

20 104. According to client statements received by the task force, auction rate securities  
21 listed on client statements have not been marked down to reflect their illiquidity. Their "estimated  
22 market value" is still listed as 100 percent of par. Certain of the exact same instruments held by  
23 Merrill Lynch in its inventory have been marked down from par.

24 **II.**

25 **CONCLUSIONS OF LAW**

26 1. The Commission has jurisdiction over this matter pursuant to Article XV of the  
Arizona Constitution and the Securities Act.

1           2.       The above conduct constitutes (1) dishonest or unethical practices and (2) failure to  
2 supervise within the meaning of A.R.S. § 44-1961.

3           3.       The Commission finds the following relief appropriate and in the public interest.

4                               **III.**

5                               **ORDER**

6           On the basis of the Statement of Facts, Conclusions of Law, and Merrill Lynch's consent to  
7 the entry of this Order,

8           **IT IS HEREBY ORDERED:**

9           1.       This Order concludes the investigation by the Commission and any other action that  
10 the Commission could commence under applicable Arizona law on behalf of Arizona as it relates to  
11 Merrill Lynch, relating to the marketing and sales of ARS by Merrill Lynch, provided however, that  
12 excluded from and not covered by this paragraph 1 are any claims by the Commission arising from  
13 or relating to the "Order" provisions contained herein.

14          2.       This Order is entered into solely for the purpose of resolving the referenced multistate  
15 investigation, and is not intended to be used for any other purpose.

16          3.       Merrill Lynch will CEASE AND DESIST from violating the Securities Act and will  
17 comply with the Securities Act.

18          4.       Merrill Lynch shall pay fines and/or penalties totaling \$125 million (the "Total  
19 Penalty") to the Commonwealth of Massachusetts and the other states, which shall be allocated at  
20 the Commonwealth of Massachusetts and the other states' discretion, to resolve all underlying  
21 conduct relating to the sale of auction rate securities. Merrill Lynch shall pay \$1,751,003.62 of the  
22 Total Penalty to the Commission. Payment shall be made to the "State of Arizona." Payment is  
23 due and shall be made in full within ten days after the date of this order. In the event another state  
24 securities regulator determines not to accept Respondents' settlement offer, the total amount of the  
25 payment to the Commission shall not be affected, and shall remain at \$1,751,003.62.

26          5.       Definitions and Buyback Offer. Merrill Lynch will provide liquidity to Eligible

1 Investors by buying Eligible Auction Rate Securities that have failed at auction at least once  
2 between February 13, 2008, and the date of this Offer, at par, in the manner described below.

3 "Eligible Auction Rate Securities," for purposes of this Order, shall mean auction rate  
4 securities publicly issued by municipalities or closed-end funds or backed by student loans and  
5 purchased at Merrill Lynch on or before February 13, 2008. Notwithstanding any other provision,  
6 Eligible Auction Rate Securities shall not include privately issued or placed auction rate securities  
7 that are unregistered and/or offered pursuant to SEC Rule 144A, or other exemptions of the  
8 Securities Act of 1933.

9 "Eligible Investors," for purposes of this Settlement, shall mean:

10 (i) Natural persons (including their IRA accounts, testamentary trust and estate  
11 accounts, custodian UGMA and UTMA accounts, and guardianship accounts) who purchased  
12 Eligible Auction Rate Securities at Merrill Lynch:

13 (ii) All small business and not for profit clients in Merrill Lynch's Global Wealth  
14 Management Group who purchased Eligible Auction Rate Securities at Merrill Lynch that had  
15 \$100 million or less in assets in their accounts with Merrill Lynch, net of margin loans, as of  
16 August 7, 2008, or, if the customer was not a customer of Merrill Lynch as of August 7, 2008, as of  
17 the date that the customer terminated its customer relationship with Merrill Lynch.  
18 Notwithstanding any other provision, "small business and not for profit clients" does not include  
19 broker-dealers or banks acting as conduits for their customers.

20 6. Tranche I Eligible Investors. No later than September 26, 2008, Merrill Lynch shall  
21 have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction  
22 Rate Securities for which auctions are not successfully auctioning from Eligible Investors who had  
23 less than \$4 million in assets at Merrill Lynch as of August 7, 2008. Merrill Lynch's offer to  
24 purchase such securities from Eligible Investors will remain open from October 1, 2008, through  
25 January 15, 2010, and Merrill Lynch shall promptly purchase such securities from any Eligible  
26 Investor who accepts this offer between January 2, 2009, and January 15, 2010.



1 For purposes of this Settlement, legal entities forming an investment vehicle for closely  
2 related individuals, including but not limited to IRA accounts, Trusts, Family Limited Partnerships  
3 and other legal entities performing a similar function, charities and non-profits, and small  
4 businesses who had less than \$4 million in assets at Merrill Lynch shall be covered by Section  
5 III.5(i).

6 7. Tranche II Eligible Investors. No later than December 18, 2008, Merrill Lynch shall  
7 have offered to purchase at par, plus any accrued but unpaid interest or dividends, Eligible Auction  
8 Rate Securities from other Eligible Investors who purchased Eligible Auction Rate Securities from  
9 Merrill Lynch prior to February 13, 2008, and who had less than \$100 million in assets at Merrill  
10 Lynch as of August 7, 2008.

11 Merrill Lynch's offer to purchase such securities from Eligible Investors shall remain open  
12 from January 2, 2009, through January 15, 2010, and Merrill Lynch shall promptly purchase such  
13 securities from any investor who accepts this offer between January 2, 2009, and January 15, 2010.

14 8. Asset Amounts. Merrill Lynch shall calculate investor asset amounts as of August  
15 7, 2008, for all Eligible Investors with assets with Merrill Lynch as of that date. For Eligible  
16 Investors with no assets at Merrill Lynch as of that date, Merrill Lynch shall calculate investor  
17 asset amounts as of the date such investor removed their assets from Merrill Lynch.

18 9. Notice and Assistance. Merrill Lynch shall provide prompt notice to customers of  
19 the settlement terms, and Merrill Lynch shall establish a dedicated telephone assistance line, with  
20 appropriate staffing, to respond to questions from customers concerning the terms of the  
21 settlement.

22 10. Relief for Eligible Investors Who Sold Below Par. No later than October 1, 2008,  
23 any investor covered by Section III.5 that Merrill Lynch can reasonably identify who sold Eligible  
24 Auction Rate Securities below par between February 13, 2008, and October 1, 2008, shall be paid  
25 by Merrill Lynch the difference between par and the price at which such investor sold the Eligible  
26 Auction Rate Securities.

11. Consequential Damages Claims. No later than October 1, 2008, Merrill Lynch shall make reasonable efforts promptly to notify those Eligible Investors covered by Section III.5 above who own Eligible Auction Rate Securities, pursuant to the terms of the settlement, that an independent arbitrator, under the auspices of the Financial Industry Regulatory Authority (FINRA), shall be available for the exclusive purpose of arbitrating any Eligible Investor's consequential-damages claim. Merrill Lynch shall consent to participate in the North American Securities Administrators Association's ("NASAA") Special Arbitration Procedures (the "SAP") established specifically for arbitrating any Eligible Investor's consequential damages claim arising from their inability to sell Eligible Auction Rate Securities. Nothing in this Offer shall serve to limit or expand any party's rights or obligations as provided under the SAP. Arbitration shall be conducted before a single non-industry arbitrator and Merrill Lynch will pay all forum and filing fees.

Arbitrations asserting consequential damages of less than \$1 million will be decided through a single chair-qualified public arbitrator who will be appointed through the FINRA list selection process for single arbitrator cases. In arbitrations where the consequential damages claimed are greater than or equal to \$1 million, the parties can, by mutual agreement, expand the panel to include three public arbitrators who will be appointed through FINRA's list procedure.

Any Eligible Investors who choose to pursue such claims through the SAP shall bear the burden of proving that they suffered consequential damages and that such damages were caused by their inability to access funds invested in Eligible Auction Rate Securities at Merrill Lynch as of February 13, 2008. In the SAP, Merrill Lynch shall be able to defend itself against such claims; provided, however, that: Merrill Lynch shall not contest liability for the illiquidity of the underlying ARS position or use as part of its defense any decision by an Eligible Investor not to borrow money from Merrill Lynch. Special or punitive damages shall not be available in the SAP<sup>1</sup>.

<sup>1</sup> However, it is agreed by the parties that "consequential damages" shall have a meaning separate and apart from "punitive or special damages." Under no circumstances should this provision be read to mean that a consequential damages claim may not be maintained due to any state law which may categorize consequential damages as a subset within punitive and/or special damages.

1 All customers, including but not limited to Eligible Investors who avail themselves of the  
2 relief provided pursuant to this Order, may pursue any remedies against Merrill Lynch available  
3 under the law. However, Eligible Investors that elect to utilize the SAP are limited to the remedies  
4 available in that process and may not bring or pursue a claim relating to Eligible Auction Rate  
5 Securities in another forum.

6 12. Institutional Investors Not Covered By Section III.5. Merrill Lynch shall endeavor  
7 to continue to work with issuers and other interested parties, including regulatory and other  
8 authorities and industry participants, to expeditiously and on a best efforts basis provide liquidity  
9 solutions for investors who purchased Eligible Auction Rate Securities from Merrill Lynch and are  
10 not entitled to participate in the buyback described in Section III.5 above (referred to herein as  
11 "Institutional Investors").

12 Beginning January 2, 2009, and then quarterly after that, Merrill Lynch shall submit a  
13 written report to a representative specified by NASAA outlining the efforts in which Merrill Lynch  
14 has engaged and the results of those efforts with respect to Merrill Lynch Institutional Investors'  
15 holdings in Eligible Auction Rate Securities. Merrill Lynch shall confer with the representative no  
16 less frequently than quarterly to discuss Merrill Lynch's progress to date. Such quarterly reports  
17 shall be submitted within 20 days following the end of each quarter and continue until no later than  
18 January 15, 2010. Following every quarterly report, the representative shall have the option of  
19 requiring a meeting between the State and Merrill Lynch to advise Merrill Lynch of any concerns  
20 and, in response, Merrill Lynch shall detail the steps that Merrill Lynch plans to implement to  
21 address such concerns. The reporting or meeting deadlines set forth above may be amended with  
22 written permission from the representative.

23 13. Relief for Municipal Issuers. Merrill Lynch shall refund refinancing fees to  
24 municipal auction rate issuers that issued such Eligible Auction Rate Securities in the initial  
25 primary market through Merrill Lynch between August 1, 2007, and February 13, 2008, and  
26 refinanced those securities through Merrill Lynch after February 13, 2008. Refinancing fees are

1 those fees paid to Merrill Lynch in connecting with a refinancing and are exclusive of legal fees  
2 and any other fees or costs not paid to Merrill Lynch in connection with the transaction.

3 14. No Disqualification. The Order entered pursuant to this Offer hereby waives any  
4 disqualification contained in the laws of Arizona, or rules or regulations thereunder, including any  
5 disqualifications from relying upon the registration exemptions or safe harbor provisions that  
6 Merrill Lynch or any of its affiliates may be subject to. The Order entered pursuant to this Offer  
7 also is not intended to subject Merrill Lynch or any of its affiliates to any disqualifications  
8 contained in the federal securities laws, the rules and regulations thereunder, the rules and  
9 regulations of self regulatory organizations or various states' or U.S. Territories' securities laws,  
10 including, without limitation, any disqualifications from relying upon the registration exemptions  
11 or safe harbor provisions. In addition, this Order is not intended to form the basis for any such  
12 disqualifications.

13 15. Nothing herein shall preclude Arizona, its departments, agencies, boards,  
14 commissions, authorities, political subdivisions and corporations (collectively, "State Entities"),  
15 other than the Commission and only to the extent set forth in paragraph 1 above, and the officers,  
16 agents or employees of State Entities from asserting any claims, causes of action, or applications  
17 for compensatory, nominal and/or punitive damages, administrative, civil, criminal, or injunctive  
18 relief against Merrill Lynch in connection with certain auction rate securities sales practices at  
19 Merrill Lynch.

20 16. For any person or entity not a party to the Order issued pursuant to this Offer, this  
21 Offer and the Order do not limit or create any private rights or remedies against Merrill Lynch  
22 including, without limitation, the use of any e-mails or other documents of Merrill Lynch or of  
23 others for auction rate securities sales practices, limit or create liability of Merrill Lynch, or limit or  
24 create defenses of Merrill Lynch, to any claims.

25 17. In Consideration of the Settlement the Commission will:  
26

1           a.       Except as allowed by paragraph 17(b), terminate the investigation by the Commission  
2 and any other action that the Commission could commence on behalf of Arizona as it relates to Merrill  
3 Lynch's underwriting, marketing, and sales of Eligible Auction Rate Securities, provided, however,  
4 that excluded from and not covered by this paragraph are any claims by the Commission arising  
5 from or relating to the "Order" provisions contained herein.

6           b.       Refrain from further investigation and from taking legal action, if necessary, against  
7 Merrill Lynch with respect to Institutional Investors until a date after December 31, 2009.

8           c.       Not seek additional monetary penalties from Merrill Lynch relating to the issues  
9 raised by the Commission relating to Merrill Lynch's marketing and sale of Eligible Auction Rate  
10 Securities to investors and the firm permitting trading in auction rates securities by any individuals  
11 affiliated with Merrill Lynch.

12           18.     Failure to Comply With Terms of Settlement. If after this settlement is executed,  
13 Merrill Lynch fails to comply with any of the terms set forth herein, the State may institute an  
14 action to vacate this Order. Upon issuance of an appropriate order, after an opportunity for a fair  
15 hearing, a state may reinstitute the actions and investigations referenced in this Order.

16           19.     This Order and any dispute related thereto shall be construed and enforced in  
17 accordance with, and governed by, the laws of Arizona without regard to any choice of law  
18 principles.

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20. This Order shall be binding upon Merrill Lynch and its successors and assigns as well as to successors and assigns of relevant affiliates with respect to all conduct subject to the provisions above and all future obligations, responsibilities, undertakings, commitments, limitations, restrictions, events, and conditions.

IT IS FURTHER ORDERED that this Order shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

  
CHAIRMAN

  
COMMISSIONER

  
COMMISSIONER

COMMISSIONER

  
COMMISSIONER

IN WITNESS WHEREOF, I, MICHAEL P. KEARNS, Interim Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 16TH day of JUNE, 2009.

  
MICHAEL P. KEARNS  
INTERIM EXECUTIVE DIRECTOR

DISSENT

DISSENT

This document is available in alternative formats by contacting Shaylin A. Barnal, ADA Coordinator, voice phone number 602-542-3931, e-mail [sabarnal@azcc.gov](mailto:sabarnal@azcc.gov).

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**CONSENT TO ENTRY OF ADMINISTRATIVE ORDER BY MERRILL LYNCH**

Merrill Lynch hereby acknowledges that it has been served with a copy of this Administrative Consent Order ("Order"), has read the foregoing Order, is aware of its right to a hearing and appeal in this matter, and has waived the same.

Merrill Lynch admits the jurisdiction of the Arizona Corporation Commission, neither admits nor denies the Statement of Facts and Conclusions of Law contained in this Order, and consents to entry of this Order by the Commission as settlement of the issues contained in this Order.

Merrill Lynch agrees that it shall not claim, assert, or apply for a tax deduction or tax credit with regard to any state, federal or local tax for any administrative monetary penalty that Merrill Lynch shall pay pursuant to this Order.

Merrill Lynch states that no promise of any kind or nature whatsoever was made to it to induce it to enter into this Order and that it has entered into this Order voluntarily.

Teresa M. Brenner represents that he/she is an authorized signatory of Merrill Lynch and that, as such, has been authorized by Merrill Lynch to enter into this Order for and on behalf of Merrill Lynch.

Dated this 1st day of June, 2009.

MERRILL LYNCH, PIERCE, FENNER & SMITH  
INCORPORATED

By: Teresa M. Brenner  
Title: Associate General Counsel

STATE OF NORTH CAROLINA; COUNTY OF MCKENNA  
SUBSCRIBED AND SWORN TO before me this 1st day of June, 2009.

James E. Dujin  
Notary Public JAMES E. DUJINS

My commission expires:  
MAY 02, 2010